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No. 08-374

In the

Supreme Court of the United States

In re Merix Corporation Securities Litigation

MERIX CORPORATION, et al.,
Petitioners

v.

CENTRAL LABORERS PENSION FUND,
Respondent

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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REPLY ARGUMENT

As explained in the petition, the decision of the court of appeals creates circuit conflicts on two important issues of federal law. First, it conflicts with decisions of other circuits regarding whether a district court must accept as true factual allegations in an amended complaint that conflict with allegations in a prior version of that complaint. Second, it conflicts with decisions of other circuits (and is inconsistent with decisions of this Court) regarding the standard to be used to determine whether claims under Sections 11 and 12 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77l, sound in fraud.

Respondent's Brief in Opposition ("Opp.") discusses at length matters that are not in contention, misrepresents arguments made and authorities cited by defendants (petitioners herein), and ignores compelling reasons why certiorari should be granted. Plaintiff (respondent herein) thus fails to overcome defendants' showing that this case meets the standards for and warrants review. *See* Sup. Ct. R. 10.

I. CIRCUIT CONFLICTS CONCERNING A DISTRICT COURT'S POWER TO CONSIDER PREVIOUSLY ALLEGED FACTS THAT ARE CONTRADICTED IN AN AMENDED COMPLAINT WARRANT A GRANT OF CERTIORARI

1. Plaintiff does not deny that there is a conflict between the Ninth Circuit's decision below and *Bradley v. Chiron Corp.*, 136 F.3d 1317 (Fed. Cir. 1998). *See* Opp. at 24-27. Instead, plaintiff argues that *Bradley* does not conflict with a different Ninth Circuit case, *PAE Government Services, Inc. v. MPRI, Inc.*, 514 F.3d 856 (9th Cir. 2007), contending that both permit a district court, "in its discretion," to strike or disregard inconsistent factual allegations in an amended pleading. Opp. at 25-26.

The Ninth Circuit did not so hold either in *PAE* or in the decision below. Rather, under the rule announced in *PAE* and followed below, a district court may strike or disregard inconsistent factual allegations only upon a showing of bad faith and in accord with Federal Rule of Civil Procedure 11. *See PAE*, 514 F.3d at 859. This rule directly conflicts with *Bradley*'s holding that a district court's inherent authority allows it to strike or disregard inconsistent factual allegations in amended pleadings, without requiring a showing of bad faith, particularly where (as here) the amendment is made by leave of court. *Bradley*, 136 F.3d at 1325-26.

Further, as appellate courts in addition to the Federal Circuit have recognized, a motion to amend may be denied on futility grounds where the proposed amended complaint relies on facts that contradict or are inconsistent with facts alleged in prior iterations of that pleading. *See Belizan v. Hershon*, 434 F.3d 579, 584 (D.C. Cir. 2006); *Reddy v. Litton Industries, Inc.*, 912 F.2d 291, 296-97 (9th Cir. 1990), *cert. denied*, 502 U.S. 921 (1991); *Asher v. Harrington*, 461 F.2d 890, 895 (7th Cir. 1972). It logically follows that where, as here, leave to amend is granted upon dismissal of a complaint and without prior judicial review of a proposed amended complaint — as is routinely done in securities cases — the court necessarily has inherent authority to ignore (or strike) contradictory allegations in the new complaint and hold the plaintiff to the facts it previously alleged. *Bradley v. Chiron Corp.*, 1996 WL 441022, *3 (N.D. Cal. July 15, 1996) (unreported), *aff'd*, 136 F.3d 1317 (Fed. Cir. 1998).[1]

The conflict between the decision below and the decision of the Federal Circuit in *Bradley* —

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[1] Plaintiff claims that "*PAE* itself dispels of Petitioners' claim that its holding conflicts with the Ninth Circuit's decision in *Reddy*. . . ." Opp. at 26. Plaintiff ignores, however, as did the panel in *PAE*, that the reason the *Reddy* complaint could not be cured was that, to survive a motion to dismiss, any amended complaint necessarily would have contradicted the allegations of the original complaint, which the court would not permit. 912 F.2d at 296-97; *see also* Pet. at 14-15 n.5.

and of the D.C. Circuit in *Belizan* and the Seventh Circuit in *Asher* — is clear and direct. Given the frequency with which complaints are amended, it is essential that courts and parties have uniform guidance on whether and under what circumstances an amended complaint's factual allegations may contradict or conflict with the allegations of a prior complaint, and how a district court may respond to any such conflict.

2. Plaintiff attempts to sidestep the conflict between the decision below and *Bradley* by asserting that "the SAC contains no factual allegations that are inconsistent with the facts pled in the [FAC]." Opp. at 28-29.[2] Plaintiff is wrong, as demonstrated by the clash between plaintiff's newly minted allegation concerning the lack of a reasonable investigation prior to issuance of the Prospectus, and the many facts pled in the FAC (but not the SAC) in an effort to show that defendants' alleged misrepresentations and omissions (including in the Prospectus) resulted from defendants' intent to "condition[ ] the market" so that Merix could "pocket[ ] more than $83 million from unsuspecting investors" while certain defendants sold personal holdings of Merix stock at inflated prices. *See* Petition ("Pet.") at 19-24 and record cites therein.

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[2] "SAC" refers to plaintiff's Second Consolidated and Amended Complaint. "FAC" refers to the first Consolidated and Amended Complaint.

In ruling that plaintiff was not foreclosed from including in the SAC allegations or claims "that are inconsistent with or contradicted by" allegations or claims made in the FAC, Petitioners' Appendix ("Appx.") 2a, the Ninth Circuit implicitly recognized this factual conflict. Indeed, the Ninth Circuit drew a legal conclusion that would have been unnecessary if the two complaints were factually consistent in material respects.

3. Not only does plaintiff fail to show lack of conflict between the Ninth Circuit's decision below and *Bradley*, but plaintiff does not meaningfully respond to the petition's discussion of the conflict between the decision below and decisions of the Fifth and Sixth Circuits (among other courts) that preclude tactical amendments of a complaint to assert "a less favorable theory" after a "theory difficult to establish but favorable" has been dismissed. *See* Pet. at 18-19 (quoting *Dussouy v. Gulf Coast Investment Corp.*, 660 F.2d 594, 599 (Former 5th Cir. Nov. 1981)).[3] The unrebutted conflict between the Ninth Circuit's decision and the *Dussouy* line of cases provides an additional, independent basis for the Court to grant certiorari.

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[3] The only case cited by defendants on this point that plaintiff mentions is *Krauss v. State Farm Mutual Automobile Ins. Co.*, 2004 WL 2830889 (Del. Super. Ct. Apr. 23, 2004) (unreported). Yet, plaintiff's discussion of *Krauss* is unrelated to the issue of tactical amendments for which defendants cited it and creates the false impression that defendants cited *Krauss* for a different point. *See* Opp. at 28; Pet. at 19.

II. CONFLICTS BETWEEN THE DECISION BELOW AND DECISIONS BY THIS COURT AND OTHER FEDERAL APPEALS COURTS WARRANT A GRANT OF CERTIORARI ON THE "SOUNDS IN FRAUD" ISSUE

1. The petition identifies two independent bases that justify review of the "Sounds in Fraud" issue. The first is that the Ninth Circuit's "necessarily constitute fraud" standard ignores and conflicts with pleading standards established in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955 (2007), and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007). Pet. at 28-32. Plaintiff's cursory response to this point ignores the import of these cases to the question presented. *See* Opp. at 23-24.

Plaintiff contends that both *Twombly* and *Tellabs* should be restricted to their specific facts and therefore do not inform the question of how a district court should determine whether a plaintiff's claims sound in fraud and must meet the requirements of Federal Rule of Civil Procedure 9(b). Opp. at 23-24. Contrary to this contention, *Twombly*'s significance extends beyond cases whose pleading is governed by Federal Rule 8(a). *Twombly* made clear that a "plausibility" assessment is essential to the district courts' gate-keeping function at the pleading stage. 127 S. Ct. at 1974. Consistent with *Twombly*, and to protect the reputation of persons falsely accused of fraud, *see, e.g., Rombach v. Chang*, 355 F.3d 164, 171 (2d

Cir. 2004), whenever a defendant raises the potential applicability of Rule 9(b), the district court should assess whether it is plausible that one or more of the plaintiff's claims are premised on fraud. If it is plausible, the district court should then assess (consistent with *Tellabs*) whether it is at least as plausible, or more plausible, that the claim is premised on fraudulent rather than non-fraudulent conduct. If the answer to this question is "yes", Rule 9(b) should apply.[4]

By contrast, the "necessarily constitute fraud" standard subjects a complaint to Rule 9(b) analysis only if it is beyond doubt that the claim is premised solely on fraud. That standard impedes the district court from performing its gate-keeping function and deprives defendants of Rule 9(b)'s protections, even if (based on facts pled by the plaintiff) fraud is the most plausible explanation for alleged misrepresentations. Because the Ninth Circuit's approach conflicts with and precludes the plausibility analysis required by *Twombly* and *Tellabs*, the Court should grant certiorari to review this issue.[5]

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[4] Plaintiff urges that it is the "master of the complaint." Opp. at 2 n.2. While plaintiffs may decide what claims to include in a complaint, courts are the final arbiters as to the characterization of those claims. *Cf. Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 147 (1987) (characterization of claim for determining appropriate statute of limitations is question of law for the court to decide).

[5] Plaintiff devotes substantial space at the beginning of its "Sounds in Fraud" section to arguing that there is no

2. In addition to the conflict with *Twombly* and *Tellabs*, the conflict between the Ninth Circuit's decision below and decisions of other circuits presents a separate and independent basis for granting the petition for certiorari.

Plaintiff incorrectly claims that no inter-circuit conflict exists, asserting that the Ninth Circuit's approach to the Sounds in Fraud Doctrine in many respects is similar to that of other circuits. Opp. at 12-16. Yet, any consistency on other aspects of the Sounds in Fraud Doctrine is irrelevant to the question posed here: whether the "necessarily constitute fraud" standard conflicts with standards used by other federal appellate courts, causing the Sounds in Fraud Doctrine not to apply within the Ninth Circuit in situations where courts in other circuits would apply it.

Plaintiff asserts as a "threshold" matter that no inter-circuit conflict exists because cases outside the Ninth Circuit have applied the Sounds in Fraud Doctrine only where (1) Exchange Act claims[6] were

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intra-circuit conflict. Opp. at 9-11. Yet, defendants never argued that an intra-circuit conflict is a basis for granting certiorari. At most, defendants noted that the Ninth Circuit's recent shift from a "gravamen" formulation for the Sounds in Fraud Doctrine to the "necessarily constitute fraud" formulation reflects that there is a substantive distinction between the two formulations. Pet. at 33 n.13. It is telling that plaintiff begins its brief with a strawman argument.

[6] Most frequently, these are claims under Section 10(b) of the Securities Exchange Act of 1934

pled in addition to Securities Act claims and/or (2) Securities Act claims "were supported by actual allegations of fraud." Opp. at 12.

These "threshold" arguments also are irrelevant to the issue here — the appropriate standard for invoking the Sounds in Fraud Doctrine, particularly when a Securities Act claim stands alone. The "necessarily constitute fraud" standard precludes the application of Rule 9(b) unless it is beyond dispute that the plaintiff's claims are fraud-based. Under that standard, as long as a plaintiff does not rely on the same facts for its Securities Act claims as it does for Exchange Act claims, and is careful to avoid magic words like "fraud" and "scienter" when pleading its Securities Act claims, there is virtually no likelihood that the Securities Act claims would be deemed to "necessarily constitute fraud." This is true regardless of how implausible a non-fraud explanation may be in the circumstances. By contrast, the standards used by the First and Second Circuits do not elevate form over substance and permit the district court to carry out its gate-keeping function by applying the Sounds in Fraud Doctrine whenever it is plausible that claims derive from fraudulent conduct and the fraud explanation is at least as compelling as any non-fraud

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("Exchange Act"), 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5.

explanation — so that fraud constitutes the essence or gravamen of the claim.[7]

The difference between these competing standards for when the Sounds in Fraud Doctrine applies is no mere "linguistic distinction," *see* Opp. at 17, as the instant case demonstrates. As

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[7] Plaintiff also mischaracterizes authorities cited by defendants. For example, contrary to plaintiff's contention, neither the First nor the Second Circuit has held that application of the Sounds in Fraud Doctrine depends on the existence of Exchange Act and Securities Act claims in the same complaint. *See ACA Financial Guaranty Corp. v. Advest, Inc.*, 512 F.3d 46, 68 (1st Cir. 2008); *Rombach*, 355 F.3d at 171. Moreover, the Securities Act claims in those cases were neither more nor less "supported by actual allegations of fraud" than are plaintiff's claims here. *See* Pet. at 34-37.

Furthermore, plaintiff inaccurately asserts that (1) defendants misrepresent the Eighth Circuit's decision in *Carlon v. Thaman* (*In re NationsMart Corp. Sec. Litig.*), 130 F.3d 309 (8th Cir. 1997), *cert. denied*, 524 U.S. 927 (1998), by "suggesting that [the Eighth Circuit] categorically refuses ever to apply Rule 9(b) to Securities Act claims" and (2) *NationsMart*'s standard for applying the Sounds in Fraud Doctrine is more lenient than the Ninth Circuit's standard. Opp. at 14-15 n.8. Both assertions are wrong because the Eighth Circuit rejects application of the Sounds in Fraud Doctrine to every claim, including Securities Act claims, for which fraud is not a required element of proof. *NationsMart*, 130 F.3d at 315; *see also Romine v. Acxiom Corp.*, 296 F.3d 701, 704 (8th Cir. 2002) ("In *NationsMart*, 130 F.3d at 315-16, we held that §11 claims do not require proof of fraud and therefore the notice pleading requirements of Rule 8(a) apply, not the particularity requirements of Rule 9(b).").

described at pages 34-37 of the petition, the SAC is replete with allegations that make it not only plausible that the SAC is premised on fraud, but show that fraud is the most plausible explanation for the alleged misstatements in the Prospectus — and therefore that the SAC's essence, or gravamen, is fraud.[8]

The analyses of Judge Rymer and the District Court, moreover, demonstrate that if the "gravamen" standard were applied to the SAC rather than the "necessarily constitute fraud" standard, the Sounds in Fraud Doctrine would be found to apply. *See* Appx. 3a ("the scheme alleged in the amended pleading walks and talks like fraud, as did the scheme averred in the original pleading"); Appx. 5a (holding that, after stripping out all fraud allegations insufficiently pled under Rule 9(b), "[o]nly a few paragraphs survive that could plausibly allege negligent conduct or negligent misrepresentations or omissions [and,] [s]tanding alone, these few paragraphs are insufficient to state a claim of negligence"). By accepting review, the Court can ensure that application of the Sounds in Fraud Doctrine to Securities Act claims will not depend solely on

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[8] That plaintiff's claims are premised on fraud is even clearer if courts may consider the additional, contradictory facts alleged in the FAC. *See supra* Part I; Pet. at 13-24.

whether a defendant is sued in Portland or San Francisco as opposed to New York or Boston.[9]

3. Contrary to plaintiff's contention, defendants do not ask the Court to grant certiorari to review factual determinations. *See* Opp. at 17. Indeed, no evidence has been presented, and no facts have been found. Reviewing a complaint to determine whether it sounds in fraud thus is not fact-finding, but a necessary step in determining whether claims, as stated in a complaint, are sufficiently pled to withstand a motion to dismiss. Appellate courts routinely review complaints for this purpose. *See, e.g., In re Ciprofloxacin Hydrochloride Antitrust Litig.*, 544 F.3d 1323, 1331 (Fed. Cir. 2008) (denial or grant of motion to dismiss reviewed de novo).

4. Plaintiff also argues incorrectly that the decisions not to grant certiorari in *Anderson v. Clow (In re Stac Electronics Sec. Litig.)*, 89 F.3d 1399 (9th Cir. 1996), *cert. denied*, 520 U.S. 1103 (1997), and *NationsMart* demonstrate a lack of meaningful conflict between the circuits. Opp. at 21-22. A denial of certiorari, of course, reflects nothing more than that the particular case may not

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[9] Plaintiff asserts that defendants "suggest on the one hand that the misstatements were so obvious that they must have known of them and intentionally lied to the market, yet on the other they argue that such allegations would be insufficient to satisfy the pleading requirements of Rule 9(b)." Opp. at 20. Defendants do not so argue. Rather, defendants assert that plaintiff's allegations, if believed, would allege a theory of fraud and therefore must be tested under Rule 9(b).

be the "appropriate forum in which to decide a significant issue." *See, e.g., Equality Foundation of Greater Cincinnati, Inc. v. City of Cincinnati*, 525 U.S. 943, 943 (1998) (Stevens, J.). The denial of certiorari in *Stac* and *NationsMart* thus has no bearing on whether a meaningful circuit conflict exists at this time on the issues presented here, which are different from the issues presented in those earlier cases. Indeed, review in those cases was sought and denied before the *ACA Financial*, *Rombach*, *Twombly* and *Tellabs* decisions significantly altered the legal landscape.

CONCLUSION

The Petition identifies (1) conflicts between the Ninth Circuit's decision below and decisions of other federal courts of appeals on the same important matters, (2) important federal questions that were decided in a way that conflicts with relevant decisions of this Court, and (3) important questions of federal law that have not been, but should be, settled by this Court. The Petition for Writ of Certiorari should be granted.

RESPECTFULLY SUBMITTED this 25th day of November, 2008.

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